Fixed Costs

Fixed Costs

The term "fixed costs" is a misnomer. No cost in government is literally fixed, unchanged from year to year. They are called fixed because managers have little flexibility in determining the level of these costs. Fixed costs consist of a basket of services consumed by District agencies in their day-to-day activities. Among them are electric, natural gas, water and sewer, fuel for vehicles, steam for heating, telephone, rent, janitorial services, security, and postage. (Figure 1-1). Yet the labels belie the complexity of these costs. Over the short-term, fixed costs are relatively stable and are not influenced by the day-to-day activities of government. But over the long-term, fixed costs typically grow with inflation and are governed by uncontrollable and unforeseen forces (weather and 9/11, for example) that underscore the challenges to District agencies in developing fixed cost estimates.

Management of Fixed Costs

Centralized management of the District's fixed costs began with the breakup of the Department of Administrative Services under the Revitalization Act of 1997. Today, four agencies develop and manage fixed costs.

1. The Office of Property Management (OPM) works with the District's real estate operations, facility management, and protective services to develop estimates for rent/occupancy, security, utilities, and janitorial costs.

2. The Office of the Chief Technology Officer (OCTO) estimates costs for telecommunication services and provides guidelines to agencies for managing their telecommunication services.

3. The Department of Public Works (DPW) manages fleet services and administers those costs.

4. The Office of Finance and Resource Management (OFRM) is responsible for the central payment of most fixed costs. OFRM pays utility bills and serves as liaison between OPM, OCTO, and the agencies that incur the fixed costs. OFRM pays 96 percent of the District's fixed costs; the remaining 4 percent is managed and paid by DPW.

Two other agencies -- the Office of Financial Operations and Systems (OFOS) and the Office of Budget and Planning (OBP) -- play key roles in the accounting and monitoring of fixed costs. OFOS ensures that proper controls are implemented by the agencies, while OBP assists agencies in including their fixed cost estimates in their annual budgets. OBP monitors fixed cost spending to ensure that agencies do not overspend their budgets.

Controlling Waste

Management of fixed costs has the important objective of minimizing waste. Fixed costs are particularly vulnerable to waste. For its part, OFRM routinely monitors bills from vendors to identify unusual activity or questionable charges. OFRM's due diligence mechanisms have resulted in significant cost savings. OCTO's Telecommunications Division is responsible for leveraging its centralized authority to bring leading providers of telecommunications products and services to agencies at extremely competitive rates. As part of this oversight, the division reviews all requests for telecommunications products to make sure they adhere to guidelines and policies. Recommendations then are made to the agencies. To cite one example: OCTO requires yearly re-certification of a user's need for a cell phone. When a cellphone no longer is needed for business, it is disconnected. For its part, DPW requires agencies to accurately track the distribution and retrieval of vehicle key cards.

Figure 1-1

Keeping the lights on and the fleet moving

Fixed cost	Description	Responsible Agency
Telecommunications	Voice and data lines, circuits, cellphones, pagers, PDAs, and other communication equipment	OCTO
Electricity	Lighting, Power for computers and equipment	OPM
Natural gas	Heating	OPM
Security	Armed and unarmed security officers provided by vendors	OPM
Custodial	Daily trash removal, cleaning, landscaping	OPM
Water	Use by agencies	OPM
Fuel	Gasoline and diesel fuel for government vehicles	OPM
Occupancy	Use of District government owned facilities by District agencies	OPM
Rent	Use of privately owned facilities	OPM
Postage	For processing and delivering mail and overhead	OPM
Steam	Heating	OPM
Fleet Services - lease	New leased vehicles and equipment and disposal services for designated agencies	DPW
Fleet Services - fuel	Fuel and lubricants to all designated District government users and other regional fleet partners	DPW
Fleet Services - maintenance	Preventive and preparatory equipment maintenance services to DPW and other designated agencies	DPW
Fleet Service - parts	Automotive parts to designated users and other regional fleet partners	DPW

Source: Office of Finance and Resource Management

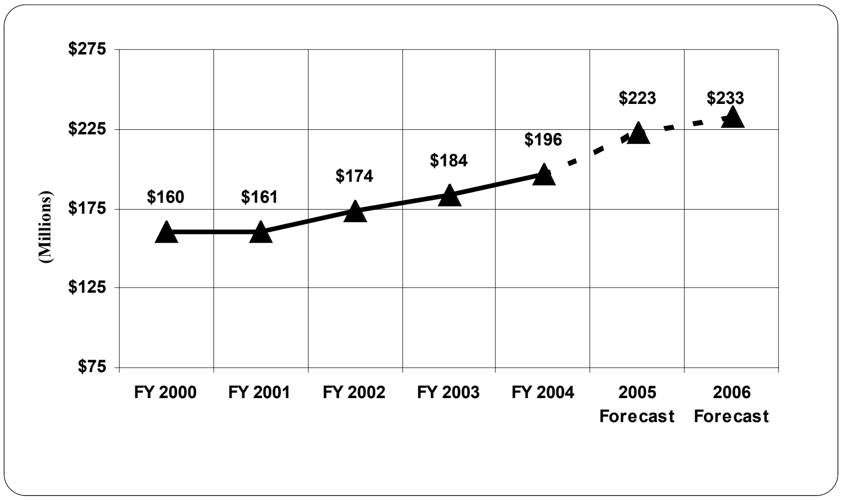
Historical Perspective

If fixed costs were budgeted as a separate agency, that agency would be the 8th largest in District government. In FY 2004, fixed costs were about $200 million. Since FY 2000, fixed costs have increased by 22 percent District-wide (Figure 1-2). This increase is due primarily to growth in rent and occupancy costs. In FY 2000, the District spent $59 million on these costs. Four years later, expenditures grew to $87 million, an increase of 49 percent, or an average increase of 12 percent annually. In FY 2004, rent and occupancy costs accounted for 45 percent of total fixed costs (Figure 1-3). Security costs also have escalated. They increased by 69 percent, from $14 million to $24 million, during the same period.

Outlook

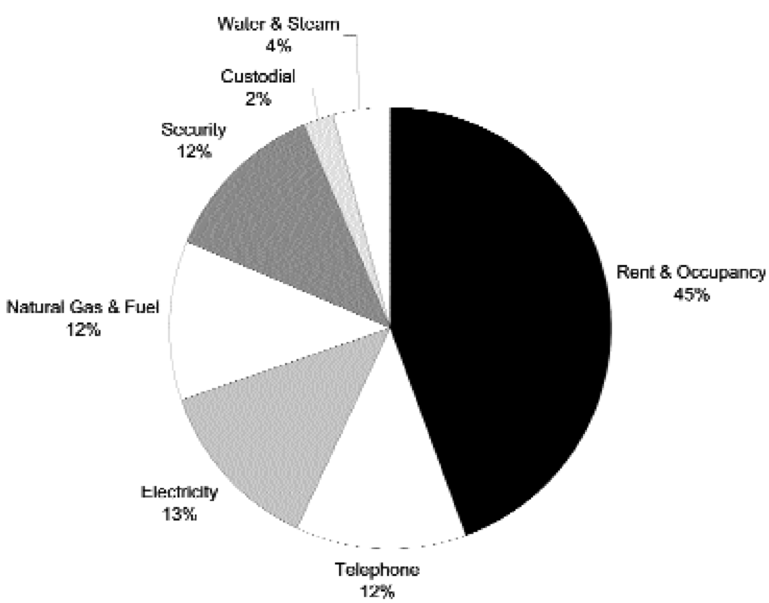
Fixed cost estimates for FY 2005 and FY 2006 are $223 million and $233 million, respectively. Rent and occupancy are expected to be the fastest growing components.

Figure 1-2
Growth of fixed costs FY 2000 to FY 2006



Source: Office of Finance and Resource Management

Figure 1-3
FY 2004 Fixed Costs by Component



Source: Office of Finance and Resource Management

Market forces have played a dominant role and affected the District's ability to develop accurate estimates for some of its fixed costs. The rapid growth of the real estate market in the D.C. metropolitan area, for example, has driven up the cost of rental property, especially in the already high rent business district. But other forces are at work, too. The deregulation of power costs pushed up the cost of electricity. These factors and others have affected the District's ability to develop accurate estimates for some of its fixed costs, often leading to spending pressures in agency budgets.

Given that the District must develop its forecast at least a year before agencies execute their budgets, assumptions must be made about the factors that will affect the estimates. Toward this end, this chapter describes the methodology for estimating fixed costs, the challenges in developing estimates, and how changes in fixed costs are made a part of the District's budget.

Why Fixed Cost Estimates are Important

The administration of fixed costs by OFRM prevents the agencies that develop fixed cost estimates (OPM, OCTO, DPW) from benefiting from either over- or under-estimating these costs. The primary goal is a well-based estimate. Underestimating could result in spending pressures. Over-estimating could mean that money is spent unnecessarily on fixed costs when it could be used for other purposes.

The existing practice of converting fixed cost estimates to agency-specific allocations is based on the space that agencies occupy. In some cases (for example, occupancy), an average per-square-foot charge is developed and is simply applied to agencies. In other cases (for example, rent), the charge for space occupied is allocated, so that different agencies pay different square-foot rates.

The initial fixed cost estimates for a given fiscal year are developed about 12 months before the start of the fiscal year. These estimates then are passed along to agencies to submit with their budget request. Fixed cost estimates then are further refined, both prior to the budget submission and throughout the fiscal year (to track spending), but the initial estimates are the basis for the budget allocations.

Prior to FY 2005, the policy regarding fixed costs was that any surplus at year-end would be returned to agencies to cover deficits in program dollars. If fixed costs were underestimated, agencies would be responsible for covering deficits with program dollars. The environment created by this policy was one in which agencies constantly sought to reduce fixed cost charges (post budget allocation) to redirect those dollars for programs. The reductions being sought may or may not have been appropriate, depending on the needs of the agencies -- for example seeking to reduce security charges below the level deemed appropriate by the Protective Services Division.

The discipline being imposed on the administration of fixed costs clarifies the program side of agencies' budgets. Funds allocated for fixed costs may be spent only on fixed costs, and funds allocated for programs may be spent only on programs. This clarity will ensure that budgeted dollars are spent as the Mayor, Council, and Congress intended.

Development of Fixed Cost Estimates

Fixed cost estimates require communication among OCTO, OPM, DPW and all user agencies. This process is highly collaborative. Input to OFRM from each agency factors directly into the development of fixed cost estimates.

The Role of the Office of Finance and Resource Management in Fixed Costs

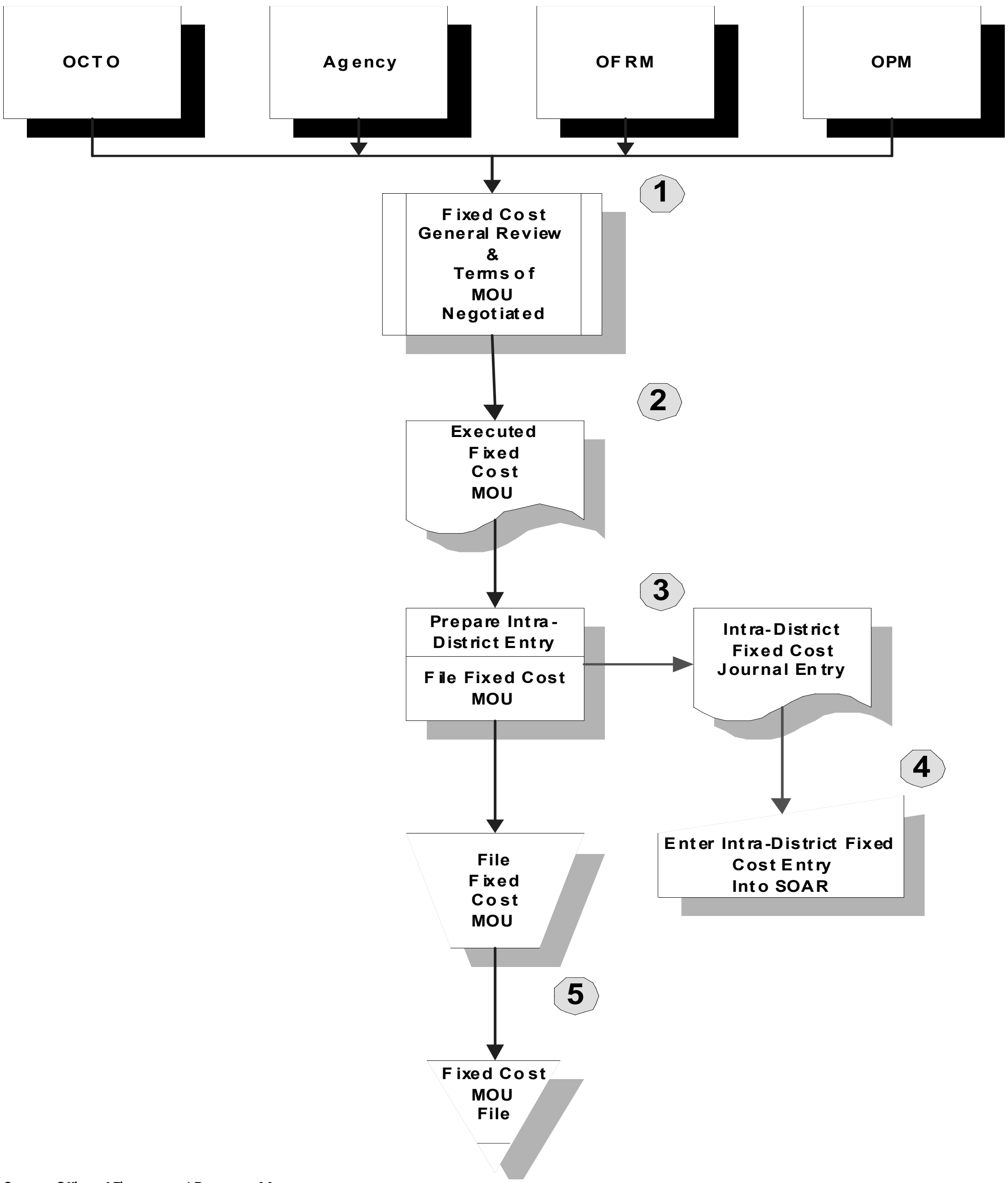
The process begins with a request from OFRM to OCTO and OPM to prepare estimates of fixed costs. OCTO and OPM deliver supporting reports, by agency, to OFRM, which them performs a due diligence review. If the review calls for adjustments, OFRM will discuss them with OCTO or OPM. Adjustments to estimates may or may not be made, depending on the persuasiveness of OCTO's or OPM's documentation supporting the estimates.

After all anomalies have been resolved, OFRM reviews the fixed cost estimates and forwards them to the agencies and the Office of Budget and Planning. OBP then includes the estimates in agency budget targets and in the Mayor's proposed Budget and Financial Plan.

From August to September, OFRM hosts the annual Memorandum of Understanding Summit to discuss MOU terms for each agency. Revisions are included in the MOUs, which are executed between agencies and OFRM (Figure 1-4). This authorizes OFRM to pay fixed cost expenditures and perform financial oversight during the fiscal year.

Figure 1-4

Memorandum of Understanding flow between agencies and OFRM



Source: Office of Finance and Resource Management

The Role of the Office of the Chief Technology Officer in Fixed Costs

The explosion of information technology (IT) during the past two decades has flooded the market with powerful new devices and technologies. "Next Generation" arrives in months, not years. Sorting through technology offerings becomes more challenging as businesses and governments turn to more sophisticated levels of technology to gain operational effectiveness and efficiencies.

The District government, recognizing that IT is the most powerful agent of change in the 21st century, created the Office of the Chief Technology Officer (OCTO) in 1998 to centralize the development and coordination of IT and telecommunications systems for the entire government. OCTO's goals are:

- Reform District government
- Position the District to be a "city of access", a model for cities in the information age
- Improve government services and support economic development
- Accelerate residents' access to District services and provide technological equality for residents

As a result of centralization of telecommunications expenditures, OCTO has minimized the reliance on costly maintenance contracts. It also has established policies for approving vendors and for reimbursing D.C. Government when employees use their DC Government cellphones and telecommunications products for personal use. The agency also applies guidelines regarding restricted use of telephones.

The Telecommunications Division manages all aspects of voice communications, including landlines, wireless, handheld devices and services, telephone equipment, telephone systems, and voice messaging. Serving as a central point of contact, the division also is responsible for establishing, monitoring and maintaining District-wide standards and procedures for services and installations.

Assumptions - OCTO's principal assumption is that the universe of IT and communications will change constantly, and that the Telecommunications Division must keep pace. Staffed by a team of Subject Matter Experts (SMEs), the division oversees telecommunications expenditures for the District and provides consultative support to more than 70 agencies.

To ensure that the division fully meets the needs of growing and demanding agency clients, the division introduced Cluster Managers (CMs) who work with their assigned groups of agencies to fully understand their operations. As the division's primary interface to agencies, the CMs marshal resources to provide agencies with creative telecommunications solutions. CMs have moved the division into a consultative partnership role with agencies, delivering customized solutions and agency-level support at a fraction of market-level prices.

The fixed cost centralized model has enabled OCTO to realize a range of benefits and improvements for the District's telecommunications spending, including:

- Creating dedicated OCTO technicians to handle repair problems and small installations, moves, and other changes at no charge to agencies;
- Negotiating to establish OCTO-approved vendors to secure reduced competitive pricing for all telecommunications products and services;
- Requiring all approved vendors to comply with D.C. government's billing format and provide invoices electronically;
- Providing expert telecommunications consultative support via OCTO's SMEs;
- Establishing and monitoring District standards for wiring and installations;
- Arranging presentations and initiating seminars where vendors present the latest products and services in the industry; and
- Creating a web-based application called Tel-WATCH that lets agencies view and validate telecommunications invoices within 10 days.

The Role of the Office of Property Management in Fixed Costs

OPM was established in 1998 in response to recommendations from the Real Estate Executive Committee convened in 1996. Consequently, a management reform plan was produced under direction of the Financial Responsibility and Management Authority. With approval of the District Council, it was determined to combine all property management functions into a single area of responsibility to further the preservation and maximization of District assets.

OPM's vision is to be the trusted real estate adviser and asset manager for the District, and to maximize the value of assets through coordination, strategic planning, financial management, business process improvement, and outreach efforts.

OPM's real estate management begins by confirming each agency's occupancy in District-owned and leased space. Fixed cost estimates then are prepared by OPM and submitted to the Office of Finance and Resource Management and the Office of Budget and Planning in October of each fiscal year. From October until the budget goes to Council in March, revised estimates may be submitted.

The fixed cost forecast covers one fiscal period and contains estimates of anticipated charges for rent, build-out, electricity, natural gas, water and sewage, fuel (unleaded gasoline, diesel fuel, heating oil), steam for heating, security services, occupancy costs, custodial services and postage.

In developing fixed cost estimates, OPM confirms what facilities an agency is using, reviews prior year expenditures, makes adjustments based on spending trends and programmatic changes, and verifies facility functions.

In multi-tenant government buildings, each agency's facility cost estimates should be consistent with the rentable area that the agency occupies. As such, each agency is charged a proportionate percentage for the annual estimated cost of the facility. The rentable area is the agency's assigned space, plus a percentage of assigned space within common areas. When an agency is the sole occupant of a facility, it is responsible for all the operational costs of that location.

A number of factors influence fixed cost forecasts. These may lead to over or underestimated costs. For example, for accurate forecasts, the following information must be shared with OPM:

- Addition of new facilities or renovation of existing facilities
- Vacating of property
- Agency relocation
- Changes in equipment and equipment specifications within agency facilities
- Storage capacity increases, such as larger fuel tanks

The following are fixed cost components and the assumptions OPM makes about them.

Rent

The District of Columbia occupies about three million square feet of leased space. Rent estimates generally include three broad categories of charges: base rent, annual escalations, and operating expense pass throughs. For the most part, base rent and annual escalations are explicit in the leases and are highly predictable. These amounts generally are not tied to variable benchmarks like increases in the Consumer Price Index. Estimates for operating expense pass throughs (including real estate taxes), however, are not as straightforward.

Assumptions - Operating expense pass-throughs happen when actual expenses for the leased facility exceed a base rate, based typically on stabilized occupancy in the first year of the lease. Because District leases have anniversary dates throughout the year, operating expenses are not always reconciled on a schedule that coincides easily with annual budgeting. Further, not all operating expenses escalate at a predictable rate. To the extent that extraordinary costs are incurred in a given lease year, such costs may not recur the following year. In making future estimates of the pass-through component of rent, inflation rates are applied to operating expenses that have been adjusted to eliminate nonrecurring costs. The difference between the future estimate and the base rate then becomes the basis for forecasting operating expense pass-throughs.

Rent estimates often are required for leases that expire in the fiscal year for which the budget is being prepared. At the time the fixed cost estimate is being prepared, it is sometimes unknown where the agency will be -- same location, another leased space, or to owned space. Estimates of rent in these instances are based on market rents in the submarket where the agency is expected to be. These fixed cost estimates represent rent to be paid to the landlord; they do not include moving or other relocating costs.

Build-out costs - These vary with the needs of the occupying agency, as well as the physical condition of the leased space. Typically, a landlord offers a tenant improvement allowance -- money per square foot that the landlord will contribute toward improving the space in exchange for the rent being offered. If the allowance is negotiated upward, the rental rate will increase proportionately. If the allowance is less, the rent will be reduced.

Impact of national rent trends. Office rents in Washington are the second highest in the country, behind only midtown Manhattan's. The driver is that the District's downtown office vacancy rate is one of the lowest in the U.S. As of the fourth quarter of 2004, that rate was 7.1 percent, down from 8 percent a year earlier. Nationally, these rates averaged 14.5 percent during the same period. Controlled new supply and steady absorption suggest that rates will continue to rise gradually for the immediate future. The fixed cost estimates reflect steadily increasing market rental rates.

Utilities

Utility costs during the last three years have been increasing for many reasons. The District of Columbia's increases come from consumption and prices.

Assumptions are about the same for all utility components:

- Expenditure and consumption data for 12 to 24 months
- Increases in energy per unit costs and in facility consumption at the agency level
- Increases in energy costs and consumption because of new or renovated facilities
- Decreases in energy costs and consumption due to renovations or vacating a location
- Increases in energy costs because of changes in facility equipment resulting in higher electric usage
- Seasonal variation in consumption

Electricity - Until recently, Potomac Electric Power Company (PEPCO) was the sole provider of electricity to District agencies. Under the existing tariff, PEPCO supplied the District with generation, transmission, and distribution of electricity. Beginning in February 2005, PEPCO has been responsible only for distribution. The District has contracted with a third-party supplier to provide generation and transmission over a two-year period. The District also purchases electricity from Baltimore Gas and Electric for facilities in Laurel and from Southern Maryland Electric for other facilities in Maryland.

Impact of national electricity trends. The cost of electricity is likely to rise for the District. Notwithstanding the current contract, the extent of the increase will depend on the number of facilities that will fall under Standard Offer Pricing as a result of District facilities coming online after the date for transferring accounts to a new supplier.

Natural Gas - Washington Gas and Light provides natural gas distribution to government facilities in the District. Generation and transmission of natural gas is provided by Washington Gas Energy

Services. For Laurel, the District also buys distribution services from Baltimore Gas and Electric and generation and transmission from Washington Gas Energy Services.

Impact of national natural gas trends. Natural gas prices have risen more than 30 percent in the past three years, but the District has had only a 12 percent increase because of its current contract. The price of natural gas will depend on demand and supply at the domestic and international levels. Given the importance of natural gas as an energy source, increases in price are likely.

Water and Sewer - The Water and Sewer Authority provides water and sewer services to the District.

Fuel - The District gets its fuel through a contract administered by the Defense Energy Support Center. The contract runs for three years and governs supplies of unleaded gasoline, diesel fuel, and heating oil. There are two suppliers of unleaded gasoline under the contract. Similarly, three companies supply diesel fuel and five supply heating oil.

Impact of national fuel trends. The cost of fuel went up sharply over the past three years because of increased demand for unleaded gas and heating oil; the cost of heating oil has almost doubled.

Steam - The General Services Administration is responsible for providing steam to agencies that use it.

Impact of national steam trends. Over the past three years, the largest increase in the cost of energy, about 18 percent, has come in steam. Its price will increase as long as the price of natural gas and oil continue to escalate.

Security

D.C. Code 10-1005 mandates The Protective Services Division, to coordinate and manage security for District government owned or leased property.

Contract Guards - These costs are based on security hours at a facility. The rate is set contractually. Hours are confirmed with each agency and reconciled with the contract guard vendor. This process occurs during the last quarter of the fiscal year to provide timely information for the upcoming fiscal year. All agencies using contract guard services pay 15 percent on every contract hour to cover Protective Services Division overhead expenses. Costs vary according to the percentage of occupancy of a particular location.

Electronic Security System Maintenance Costs - These are driven by the electronic equipment in the facility. Each piece of equipment, in each facility, is assigned a unit maintenance cost. This cost is borne or shared by the agency or agencies in the facility.

Salaries - Protective Services Division personnel permanently assigned to the John A. Wilson Building and the D.C. General Campus have their total salary costs borne by their respective facilities. The 15 percent contract administration/management fee covers remaining staff salaries.

Assumptions - If funds for security were paid in full by agencies by October 30, Protective Services could enter contracts at the beginning of the fiscal year that would last until the end of the fiscal year. Based on current collection practices, the purchase requests for these two largest contracts must be re-inputted twice a year. One full collection would eliminate that necessity.

Impact of national security wage trends. At a minimum, contracts are paid according to the Department of Labor's Wage Determination. The unpredictable Wage Determination increases and their effective dates are set by the Department of Labor. The increases are implemented at the beginning of the exercised option year. Frequently, this increase occurs after the District government agencies' budgets are set. The last three years have seen three increases ranging from 3 percent to 6 percent.

Occupancy Costs
Occupancy is charged to all agencies that occupy space in District-owned buildings. The annual occupancy charge per square foot is $4. Preventive maintenance for the day-to-day operations of buildings, as well as major repairs, is funded with occupancy funds for air conditioning, boiler, generators, and elevators.

Impact of national occupancy trends. The General Services Administration and commercial realty companies charge their tenants market rate for these services. The District currently charges an amount that is significantly less.

Custodial Services
These funds cover costs of providing janitorial, trash removal, and recycling services. The services are provided by competitive citywide contracts that are awarded through the Office of Contracting and Procurement. The cost for the citywide contract is the actual cost that the agencies pay for services based on square feet they occupy and services they receive.

Postage
Estimates are based on a three-year use average. In addition to actual meter costs, agencies are charged overhead equal to their percentage of meter use. Overhead covers salaries, equipment, and postal supplies.

The Role of the Department of Public Works in Fixed Costs
DPW provides maintenance, parts, and vehicular acquisition services for about 3,000 DPW vehicles and 35 other District agencies, departments and commissions so that they can deliver timely and efficient services. In addition, the fleet management program provides fuel and fluids to more than 6,000 vehicles, including those maintained by the program and others belonging to D.C. Public Schools, the Metropolitan Police Department, FEMS, and the Water and Sewer Authority.

Fixed costs include fuel, maintenance, and parts. Estimates are developed based on prior year actual spending, and include a three-year average, market rates, and inflation rates set by OBP. In addition, consideration is given to each agency's actual rate of unscheduled maintenance. Agencies must work with DPW to ensure that all fleet cost estimates are accurate in reflecting potential consumption and charges.

Assumptions are based on the number of vehicles assigned to an agency and actual levels of service and fuel consumption by that agency. In making estimates, DPW uses these values:

- Parts - actual costs plus 25 percent administrative/processing fee
- Fuel - actual cost plus 10 cents to 20 cents per gallon administrative fee
- Contract maintenance - actual cost plus a 15 percent administrative fee
- Leasing - varies with size, type, and year of vehicle and actual costs, plus administrative fee
- Motor pool rental - flat rate
- Vehicle repairs/preventive maintenance (heavy/medium equipment) - $59.50 hourly shop rate
- Vehicle repairs/preventive maintenance (light equipment) - $49.50 hourly shop rate.

Recommendations

Improve Forecast Accuracy

- **OFRM** currently conducts quarterly reviews of agency telecommunication expenditures. Currently, nearly 50 percent of all agencies and nearly 90 percent of large agencies must adjust their budgets during the fiscal year. Generally, needs surface during critical moments. Trying to gather key players to negotiate improvements is difficult and time-consuming. By establishing quarterly sessions, agencies can adjust budgets to eliminate costs for missed deadlines and delays of key installations due to lack of funds.
- **OPM** is creating a formal means by which agencies communicate information to the Facility Management Division. Until now, notification has been informal. Requiring formal notification will hold both OPM and the client agencies accountable for over and underestimating.
- **DPW** is using a better way to forecast one of its major fixed costs: vehicle replacement. In prior years, vehicles typically were replaced based on age. Now, because of new automotive technologies and efficiencies, DPW can weigh the real-cost benefit of replacement. For example, DPW can capture accurately and analyze the total cost of maintaining a vehicle versus measuring only current value and age, to better determine the District's replacement requirements. DPW also is planning a new IT system that will show maintenance costs by vehicle category -- pickup truck, full-size sedan - to refine forecasts.

Avoid Waste and Abuse

- **OCTO** suggests establishing a Joint Applications Development Team (JAD) to quickly test products, applications, updates and enhancements with a knowledgeable team of end users. The JAD team will consist of ATCs from five to eight agencies and a review of the team's makeup will be made annually. The JAD team will eliminate problems OCTO and end users now face with application changes not being tested with end users before implementation, which has resulted in costly, wasteful downtime. The agency also suggests that vendors notify OCTO when cellphone usage has significantly exceeded plan thresholds. OCTO then will review and forward all significant overages to agencies for immediate handling. Agencies will be given a month to implement recommended usage savings plans. After the deadline, cellphones will be suspended.
- **OPM** suggests that the District may want to consider increasing occupancy charges to agencies. Another option is to charge one cost for full facility management services that includes all services mentioned in this chapter. Under this option, OPM can provide full services. The only additional cost to agencies would be major renovations or improvements to their space. Although OPM will conduct an extensive analysis to determine the appropriate level of funding for occupancy, it is widely accepted that occupancy charges are too low relative to the private sector. Ultimately, a larger ongoing investment in repair and preventive maintenance will have a favorable impact on the capital budget. Also, OPM is assessing ways of making more use of such passive security devices as cameras and other electronic devices in place of more expensive manned security.
- **DPW** believes SUVs should be limited to District officials whose work requires them. This will help reduce emissions and fuel consumption and encourage the use of alternative fuels, consistent with the Mayor's and Council's policy. Other officials would be assigned mid-size or compact cars or trucks. In other moves to curb waste, DPW monitors all bills from vendors to agencies, to identify unusual activity or questionable items. DPW's cost-effective management of fleet services has saved millions of dollars in potential waste and abuse. One initiative involves revised forms to improve the quality of pre and post trip inspections for commercial vehicles. Fleet professionals use inspection items on the form to provide quality checks. The goal is to promote accountability and involvement. Fleet will evaluate the effectiveness of this concept and promote this process District-wide.

Conclusion

Controlling fixed costs is an important way to save money so that other, more necessary services can be delivered to District residents without increasing taxes. Efforts toward this end are under way throughout the District. Market-driven deviations from cost estimates always will occur, but the District's mission is to minimize their impact by first providing well-based estimates, then delivering the service with maximum efficiency and minimum waste.